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Regarding the risk of a disorderly adjustment (of the U.S. trade deficit), it should be emphasized that any excessive current account deficit will need to adjust eventually. What cannot last will not last. The crucial issue is whether the adjustment will be orderly or involve a large and disruptive change in key economic variables. Such a disorderly adjustment would affect not only the rest of the world but, in particular, the deficit country itself. There is a number of factors which may increase the risk of a disorderly adjustment.

—Dr. Ottmar Issing, board member of the European Central Bank

CURRENCY TROUBLES ARE ECONOMIC TROUBLES

The dollar has slumped to new lows against several currencies, the gold price has hit a seven-year high and stock markets are faltering. Yet worldwide economic news is far better than had been expected. Not only has the U.S. economy sharply rebounded, but Japan and the euro area are also growing again, albeit very slowly. The Organization for Economic Cooperation and Development's early indicator for the G7 countries is giving its most upbeat signal since 1994. But emerging Asia, propelled by skyrocketing Chinese import demand, is booming as never before.

In fact, it is a most unusual and unprecedented global economic situation. In the general perception, the U.S. economy is leading a new global recovery. It is rigmarole. This time, the global engine of growth is China. Its purchases of goods from abroad surged 41% in the first nine months of 2003, positioning it to pass Japan as the world's third-largest importer, behind the United States and Germany. U.S. imports, for comparison, increased at the same time by just $10 billion, or 3%.

As to the U.S. economy's recovery, it is necessary to distinguish between two grossly diverging kinds of economic indicators: *first*, artificial, so-called forward-looking indicators, such as consumer confidence surveys, the Conference Board's Index of Leading Economic Indicators and the Institute of Supply Management indexes for manufacturing and non-manufacturing; and *second*, the hard data of actual economic activity provided by the official statistics.

But in the official activity data, there is a glaring discrepancy between the movements on the demand side and supply side. Consumer spending has been strong, while industrial production, employment, and wage and salary incomes have been flat or down for three years. By these measures, the U.S. economy is close to depression.

Later in the letter, we present a detailed comparison of the behavior of key economic aggregates between past recoveries and the present one. It is a comparison that shocks. For sure, real GDP has grown, in particular in the third quarter of 2003, but looking at its grossly skewed pattern, we don't see a genuine self-sustaining "recovery," as exemplified by past experience.

Compared to all prior postwar recoveries, the present one is phony. Its pattern is phony, its momentum is phony and the forces that have propelled it are phony. The third-quarter's 8.2% GDP surge reflects a one-off burst in consumer spending driven by tax rebates and the mortgage refinancing bubble.

Never before in history has an economy been treated with such profligate monetary and fiscal stimulus as the U.S. economy was in 2003. Think of the rock-bottom interest rates, of the exploding budget deficit, of record-high debt growth, of the housing and mortgage refinancing bubble allowing for huge homeowner equity extraction — and then think of the miserable result: America's slowest economic recovery of all times after a recession.

A MISPLACED BOAST

In order to judge whether something is good or bad, it needs, of course, a reasonable measure. Surely not just by accident, American policymakers and economists like to contrast the performance of their apparently dynamic economy with that of the famously "sclerotic" economy of the eurozone.

We object to this popular comparison for two main reasons: first of all, it deludes about America's serious problems; and second, it is a disparate comparison when one considers the enormous differences in policy stances. In the United States, both monetary and fiscal policy have thrown demand stimulus of unprecedented size and unprecedented kind at the economy, while Europe's governments and central bank have exercised distinguished reluctance, despite weak economic growth.

We think this glaring difference in policy stances has an obvious reason. American policymakers are in a panic about the probable disastrous ripple effects of a double dip on the economy, financial system and its currency. They know very well of their great vulnerability. Just as clearly, central bankers in Europe are not in a panic, and that too has an obvious reason. Europe has not had the credit and debt excesses that have ravaged America's economy and financial system.

For sure, the U.S. recession of 2001 was the mildest in postwar history. Real GDP declined just 0.6%. That is well below the average 2% decline of previous postwar recessions. The great question, of course, is what actually made this recession so mild? Quoting Fed Chairmand Alan Greenspan from a congressional testimony on July 17, 2002: "*The mildness and brevity of the downturn are a testament to the notable improvement in the resilience and flexibility of the U.S. economy.*"

Most probably that is a widespread, if not the consensus, view among American economists. It needs drastic revision. Indeed, the 2001 recession was unusually mild, but this positive has been more than offset by unusually weak economic growth in the two years that have followed the recession.

As just mentioned, the decline of real GDP in all postwar recessions has averaged 2%. But this loss was always followed by vigorous recoveries, averaging a cumulative 10.2% in the following two years. Over the three years embracing recession and recovery, there was net GDP growth of 8.2%

Now to the present development. True, the recession in 2001 was unusually mild, but that is no reason to boast because this brief positive has been more than offset by the unusually anemic economic growth during the two years that followed this recession. Over the three years 2001–03, covering recession and recovery, real GDP has grown in total by 5.7%, compared with an average of 8.2% in commensurate three years of recession and recovery in five postwar recessions.

In actual fact, the U.S. economy has in the past three years performed at its worst in the whole postwar period. In light of this fact, any boast about a particularly mild recession, being tempered by the economy's new extraordinary resilience and flexibility appears grossly misplaced. In face of the unprecedented monetary and fiscal stimulus pumped into the economy during these years, it is absurd. In actual fact, it also suggests extremely poor policy traction.

But in our view this talk about the economy's resilience and flexibility is grossly misplaced for still another reason. What has truly happened during the past few years in the United States is the precise opposite of flexible adjustment: utter financial inflexibility on the part of consumers and businesses. Recessions were always periods of sharply slower debt growth or even debt repayment, reflecting retrenchment in spending.

The 2001 recession, in contrast, was a period of most rampant debt growth, and in fact, that is precisely what the Greenspan Fed wanted to achieve. In a speech on March 4, 2003, in Orlando, Fla., Mr. Greenspan bragged about the fact that consumers had been extracting huge amounts of previously built-up equities from owner-occupied homes. For the economy, such equity extraction as a whole is, of necessity, financed by debt.

During the second quarter of 2002, the last quarter for which debt data are available, consumer borrowing ballooned at a record annual rate of $1,000.2 billion and business borrowing at a record annual rate of $480.3 billion. During the 1991 recession, consumer borrowing fell from $235.2 billion to $186.8 billion and business borrowing from 127.7 billion to –$84.4 billion. For fully two years, businesses repaid debt.

Just recently, Mr. Greenspan hailed that consumer and business balance sheets were strengthening. In the case of the consumer, it has come from inflating stock and house prices, and in the case of businesses from lower spending on fixed investment and inventories. Yet debts keep soaring.

A HISTORICAL PERSPECTIVE

All past recessions, in actual fact, resulted from tight money and credit forcing consumers and businesses to curb their borrowing and spending excesses of the boom. Inherently, this brought the economy and the financial system back into balance. What's more, prompt retrenchment was regarded as necessary and desirable.

But in the United States this policy principle has been put literally on its head in the past few years. While borrowing and spending excesses have been at their worst during the past bubble years, the Greenspan Fed has been desperate to foster ever more bubble-driven spending, now ranking under the respectable label of "wealth-driven" spending.

But first of all, we would like to put the U.S. economy's performance during the past three years into perspective, that is, since the start of its recent recession.

PEAK-TO-TROUGH PERCENTAGE CHANGES IN KEY ECONOMIC AGGREGATES DURING RECESSIONS

	AVERAGE OF SIX RECESSIONS	1990–II TO 1991–1	2000–III TO 2001–III
REAL GDP	–2.0	–2.2	–0.02
PERSONAL CONSUMPTION	0.7	–1.1	1.8
PRODUCER EQUIPMENT	–10.8	–4.3	–8.2
NONRESIDENTIAL STRUCTURES	–4.2	–7.4	–2.1
RESIDENTIAL INVESTMENT	–10.7	–18.7	2.4
INDUSTRIAL PRODUCTION	– 8.2	– 2.8	–4.1
PRIVATE EMPLOYMENT	–2.7	– 1.1	–.1
REAL DISPOSABLE INCOME	0.1	–1.0	2.8
REAL WAGE AND SALARY INCOME	– 2.0	– 2.5	1.9

PERCENTAGE CHANGES IN THE ECONOMIC AGGREGATES DURING THE FIRST EIGHT QUARTERS OF RECOVERY

	AVERAGE OF FIVE RECOVERIES	1991–1 TO 1993–1	2001–III TO 2003–III
REAL GDP	10.2	4.2	2.8
PERSONAL CONSUMPTION	9.9	4.4	6.1
PRODUCERS EQUIPMENT	21.4	18.6	7.9
NONRESIDENTIAL STRUCTURES	4.8	–13.7	–3.6
RESIDENTIAL INVESTMENT	36.7	23.7	15.9
INDUSTRIAL PRODUCTION	17.9	6.2	1.6
PRIVATE EMPLOYMENT	6.6	0.5	–1.3
REAL DISPOSABLE INCOME	9.0	4.4	6.1
REAL WAGE AND SALARY INCOME	9.0	1.9	4.3

We have to say that we owe the numbers both for the postwar "average" and the slow-growth period of 1989–92 to a study published in the *Quarterly Review, Summer 1993*, of the Federal Reserve New York.

The first table shows the decline that happened on average for the various aggregates during the year of recession. The second table shows the gains in these same aggregates during two years following the recession. Interestingly, all declines were succeeded by far more vigorous rebounds. Comparing the “pains” of the recession with the “gains” in the recoveries, the latter were always overwhelming.

Manifestly, the 2001 recession was not a typical downturn. Nor is the present upturn a typical recovery. Both differ dramatically from the pattern of past recessions and recoveries. Earlier we said the U.S. economy’s recovery of 2002–03 is phony. Its pattern is phony, its momentum is phony and the forces that have propelled it are phony.

More succinctly: *first*, the pattern of the present U.S. economic recovery is grossly biased towards consumption; *second*, it grossly lacks momentum; and *third*, it has been driven by an unsustainable, extraordinary bout of monetary and fiscal stimulus and infinite credit and debt excess.

MANUFACTURING DEPRESSION

But assessing the U.S. economy’s recent development as well as its prospects, one of the most malign and dangerous features has not been recognized in general because the focus is on GDP and not on the various sectors. This most malign and dangerous effect is the virtual massacre of the manufacturing base that started in the late 1970s and dramatically gathered pace during the last few years.

In past cyclical recoveries (see table), industrial production has always rebounded the fastest among all aggregates. On average, it has surged by 17.9% in the first two years after recession. This time, it has barely budged since the recession ended in late 2001 and is 5% below its peak level in 2000. The total number of factory jobs lost since the start of the last recession in early 2001 is 2.4 million.

From its peak five years ago in 1998, manufacturing employment has plunged 3.1 million, or about 18.3%. This is the single greatest percentage decline in the labor force in almost seven decades since the Great Depression of the 1930s. What has been happening to American manufacturing can only be described with the word depression.

The thing to see — but which nobody does — is that this contraction in America’s manufacturing base is by no means temporary. It plainly represents a sharp downward plunge within a long-term structural downward trend.

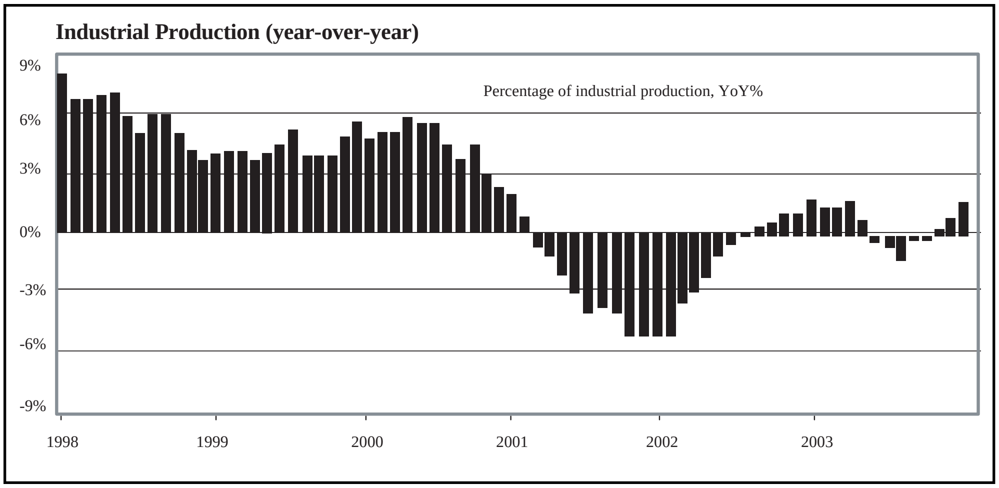
BUT BOOMING HEALTH SERVICE

In the Oct. 27, 2003, issue of *BusinessWeek*, we read with great interest an article called “JOBS: THE TURNING POINT IS HERE.” What attracted our particular attention was a table titled, “*A Jobless Recovery? That Depends*.”

Obviously, the author wanted to convey the positive message that the extremely poor employment performance of the manufacturing and high-tech sector had a strong counterpart in other sectors of the economy. We read something else. More than many words, the table confirmed to us that the U.S. economy is in a wrenching structural crisis. The production side with high-paying jobs is contracting, while the consumption side with low-paying jobs is booming.

Measured since the end of recession, the main job losses occurred in the following sectors (in thousands): manufacturing 1,269; wholesaling 161; telecommunication services 150; computer systems design and related services 108; air transportation 63.

And here is where employment has grown (also in thousands): health care and social assistance 540; temporary help service 110; accommodation and food service 110; government 104; construction 51;



commercial banking 29; real estate 28. The gains of the latter three are, of course, related to the housing and mortgage refinancing bubble.

Plainly, this sharply divergent employment performance perfectly reflects the economy's grossly distorted spending and growth pattern. While the production side is collapsing, the consumption side is booming. At the same time, these numbers suggest how stupid it is to look only at the monthly net changes in total employment.

This sharply diverging employment performance is, in essence, a measure of the accelerating macroeconomic shift in the U.S. economy's structure away from goods production and toward services. It is a development that American policymakers and consensus economists have been hailing as a normal and natural structural shift for a highly developed economy.

This complacent view ignores two snags of crucial importance. First of all, manufacturing is the sector that pays the highest wages everywhere. Second, it is the key source of foreign earnings that pay for the foreign obligations of every country. America is now at the disastrous point where current exports of goods cover only 56% of current imports of goods. It is in fact normal that manufacturing produces more and more goods with less and less people. But the American case is different in that the production of goods increasingly lags the current growth of demand and incomes.

THE PRODUCTIVITY HOAX

We keep reading that the reported miraculous productivity gains have become the main driver of U.S. GDP growth. The favored explanation is that this is yet another benefit of the New Economy. What are the others, we ask ourselves. By rapidly increasing use of the new information technologies, according to the general assumption, businesses are able to squeeze ever-increasing value out of the average worker. As this implicitly boosts profits, the impending comeback of business investment spending is taken for granted.

Reported labor productivity has grown at an average annual rate of 5.4% over the last two years, and in the third quarter even at an annual rate of 9.1%. There seems to be unanimous admiration. For us, these numbers are simply unbelievable in the first place. But it is outright absurd for a country that is experiencing a drastic employment shift away from high-paying and notoriously highly productive manufacturing jobs into low-paying and low-productive health service jobs.

That is our first counterargument. But there are several other ones. There seems to be a consensus among American economists that — quoting a leading economist — *"Productivity growth is the single most important factor affecting our economic well-being. Productivity is not everything. But in the long run, it is almost everything."*

The high opinion of the singular importance of productivity growth is actually unique to American economists. In conspicuous contrast, the great European economists have rarely or never mentioned it. Without doubt, they were fully aware of the importance of productivity growth. But they regarded it as chiefly a function of capital investment. As a rule, where there is high capital investment, high productivity growth can be taken

for granted. And by the way, capital investment also provides the increase in demand and spending that is necessary to translate growing productivity into effectively higher employment and economic growth.

Faced with the unprecedented coincidence of record-high productivity growth and plunging employment, American economists have immediately invented a convenient explanation: high productivity growth essentially goes hand in hand with jobless economic growth.

Nothing could be further from the truth. This has never happened before. Accelerating productivity growth has always coincided with rapid job creation, and that had its obvious cause in the strong capital investment that created this productivity growth. Producing capital goods, by the way, is typically labor-intensive. What's more, the old-fashioned productivity growth also involved genuine wealth creation through building factories and installing machinery.

America's recent stellar productivity growth has plainly nothing to do with high capital investment. Net investment has collapsed. Somehow, the productivity miracle of the recent years has come out of the blue. In our view, it must have more statistical than economic causes. We do not believe in numbers, we believe in economics, and there is no reasonable economic explanation for this extraordinary productivity growth.

Our strong doubts about the validity of the reported productivity figures begin with the conviction that real GDP growth is considerably overstated by inflation rates that have been systematically trimmed to the downside. Just take the hedonic pricing of computers. Over the past several years, this alone has on average accounted for 25–30% of real GDP. Of course, that enters equally into the productivity numbers.

The fact is that the concept of measuring inflation rates prevailing in the United States differs radically from that of all other countries. Around the world, the basic idea is to measure effective price changes. In America, it has intrinsically become the underlying idea to measure consumer satisfaction or well-being.

As a result, quality improvements and so-called substitution effects play a great role in reducing inflation rates. "Substitution" refers to the way consumers alter their pattern of purchases in response to relative price. If beef prices rise, the consumer buys chicken.

All in all, we estimate that owing to these and other statistical gimmicks, America's inflation rates are understated by around 2 percentage points per year, compared with the measuring practices in most other countries. And that means a commensurate overstatement of GDP and productivity growth.

In any case, it has to be realized that productivity growth arising mainly or fully from falling employment lacks any gain for the economy. To boost living standards and profits, the productivity growth must be accompanied by an improvement in some other kind of performance, such as higher output, higher exports or higher investment. Just by itself, it only means rising unemployment or a change in the distribution of income.

GOODBYE HEDONIC COMPUTERS

According to conventional reports, the great rebound in business investment spending is already in full swing, though primarily in new high tech. It was widely and respectfully reported that inflation-adjusted high-tech outlays of businesses in the third quarter had expanded at an annualized rate of 22%, and that it was standing 13% higher year-over-year.

In the last letter, we pointed out that this perceived investment rebound derived completely from hedonic pricing of computers. In current dollars, computer investment had increased just $11.5 billion, as against an increase by $92.7 billion. The hedonic price component accounted for 26% of the recorded real GDP growth year over year.

Now, with the benchmark revision of the GDP data, something unbelievable has happened. In their

comments to the revisions, the Bureau of Economic Analysis declares: "The inflation-adjusted figures for investment in computers is no longer published because Commerce was concerned the rapid price declines for computers made the figures misleading. Now only the actual figure is published."

Reading these lines, one formulation has struck us as rather odd. They do not say, the Bureau of Economic Analysis is concerned, but that Commerce was concerned. We assume they were forced by their superiors in the Commerce Department to make this change. In the new tables for Real Private Fixed Investment, the line for computers and peripheral equipment is blank. This treatment is, of course, only a different nonsense.

For years we have been assailing this hedonic pricing of computer investment, capturing rapid increases in computer power and turning these into steep price declines which, in turn, translated into correspondingly higher GDP and productivity growth. Implicitly, the calculated extremely high productivity growth resulted from the production of computers, not from their use. But all the talk of the high productivity effects of computers logically relates to such effects from their use, and of these we know in reality nothing because they are impossible to measure. We have always wondered whether this was systematic misinformation.

But our rigorous objection had still another major reason. Economic activity is plainly governed by actual money flows being spent or received. The hedonic pricing of computers created absurdly exaggerated perceptions of the money being spent and earned on computers.

In hedonic prices, the computer producers enjoyed a stellar increase in revenue by $128.2 billion, or 49%, from $262.1 billion to $390.3 billion between first quarter 2002 and third quarter 2003. But in actual dollars, the gain was only $16.4 billion, from $71.9 billion to $88.3 billion. The hedonic dollars created a boom for what in actual current dollars a trickle. From an economic perspective, this contrast is absurd.

It is, by the way, our opinion that the economic importance of the new high-tech technology industries has been and continues to be ridiculously overhyped in the United States. In terms of sales, employment and earned profits, it is a sector of minor importance. Their profit performance has been abysmal over time.

Saying this, we have the Industrial Revolution in mind. Implementing the new technologies, it involved radical changes across the economies, requiring and creating huge new industries with soaring employment. It radically changed economic and personal life. By comparison, the new high-tech industries are of marginal importance.

PROFIT RENAISSANCE?

Recent profit reports about the U.S. economy, also from the official NIPA accounts, are certainly highly impressive. For easily identifiable reasons, there has been substantial improvement since the profit low in the recession year.

However, there is a variety of profit aggregates telling somewhat different stories. Most economists have a great liking for the most comprehensive figure — corporate profits with inventory valuation and capital consumption adjustments. For us it is the fuzziest number. It includes the financial sector and now exceeds $1,000 billion, and since its low in the recession years it has increased by about 50%.

Being mainly interested in what happens inside the real economy, our focus has always principally been on the nonfinancial sector. Its before-tax profits hit a low of $333.7 billion in 2001, the recession year, compared with a peak of $504.5 billion in 1997. According to the revised data, in third quarter 2003 it scored a new high of $384.5 billion. In manufacturing, present profits are no higher than in the recession year. The overall gain for the sector has overwhelmingly come from retail trading.

Before we continue, we have to admit something. It has been quite a while since we took a closer look at profits. The reports about rising profits did not amaze us. Every recovery, even if it is weak, ought to improve profits. Also we realized that there were various special influences at work buoying U.S. corporate profits.

There are currency gains from the profits of foreign subsidiaries in countries with rising currencies against the dollar, and we also suspected considerable financial profits from the various bubbles.

But in particular we expected a major contribution to profits from the big shift in the funding of consumer spending from income-driven to bubble-driven. Sacking labor, of course, slashes costs. In the same vein, though, it slashes the incomes that buy the goods from which the producers make their profits. However, this did not happen because the consumer replaced his income loss by heavy borrowing against rising house prices.

While income-driven spending slumped, bubble driven spending surged, and that implicitly gives a big boost to profits. That is because income-driven spending derives from wages and salaries, being business expenses. In contrast, credit-financed spending makes a net addition to business revenues.

There is an illusion about cost cutting as a profit source. As we have emphasized many times, individual cost cutting tends to have this effect. But widespread cost cutting essentially translates simultaneously into widespread revenue cutting for business, with both effects canceling each other out. What turned the cost cutting of the last few years profitable for businesses was the fact that the consumer increased his spending despite heavy income losses by higher borrowing.

DOLLAR AT THE ABYSS

After all, the dollar is sharply depreciating again against all floating currencies. Remarkably, this is happening despite much good news about the economy apparently pointing to strong growth in 2004 and further rises in stock indexes.

The dollar's plunge has certainly taken many people, currency experts of banks included, by surprise. For many of them, it still is incomprehensible. Recently, we heard somebody on CNBC saying that he is at a complete loss to understand how such a weak economy like that of the eurozone can have a strong currency.

For America's policymakers and most economists, the huge trade deficit is no problem. They find it natural that fast-growing countries import capital while slow-growing economies export their surplus savings. In essence, such a deficit, indeed, indicates that investments exceed domestic savings. The argument is that it makes economic sense when high-saving countries export their saving surplus to a low-saving country that wants to grow faster, like the United States.

Every sentence in that paragraph is perfectly true, and yet it makes complete economic nonsense by grossly distorting realities. It is by definition true that a trade deficit essentially reflects an excess of investment over domestic saving. In the U.S. case, however, the reason for this investment excess is not a high rate of investment but abysmally low national savings.

If not even more skewed is the second argument that capital flows from high-saving countries to low-saving countries, wanting to grow faster, makes perfect economic sense. Basically, a deficit country, taking consumption and investment together, is absorbing more than its own production. But whether this is good or bad for the economy essentially depends on the nature of the use to which the foreign funds are put. Are they financing consumption in excess of production or investment in excess of saving? That is the key question that ought to be asked in the first place about the huge U.S. capital imports.

To quote Joan Robinson, a well-known economist in the 1920–30s close to John M. Keynes: "*If the capital inflows merely permit an excess of consumption over production, the economy is on the road to ruin. If they permit an excess of investment over home saving, the result depends on the nature of the investment.*"

There can not be the slightest doubt that the huge U.S. capital inflows, accounting now for more than 5% of GDP, have not financed productive investment. America's net investments are among the lowest in the world. The huge capital inflows have not helped finance a higher rate of investment. America has been selling its

factories and financial assets to pay for consumption.

THE TRUE MEASURE OF ECONOMIC STRENGTH

What America's capital inflows ultimately financed was an unprecedented escalation of personal consumption as a share of GDP. The important point to see is that the steep decline in personal saving has its implicit counterpart in the economy in an equivalent rise in the share of output that is consumed. And that, in turn, must essentially translate partly into lower capital investment and partly into a growing current-account deficit. It needs saving to make investment possible.

But if the U.S. economy is in such bad shape, as we manifestly think, how does this conform with the fact that it has for years been the strongest in the world, even pulling the rest of the world with it?

The fact that the U.S. economy has outperformed the rest of the world in the past several years has one reason that is obvious and also easily explained. That is its credit machine that has no parallel in world. It is geared to accommodate absolutely unlimited credit for two purposes — consumption and financial speculation.

There has developed a tremendous and growing imbalance between the huge amount of credit that goes into these two uses and the minimal amount that goes into productive investment. Instead of moving to rein in these excesses and imbalances, the Greenspan Fed has clearly opted to sustain and foster them.

Today it is customary to measure economic strength by simply comparing recent real GDP growth rates. It always becomes fashionable when U.S economic growth is higher than in Europe.

From a long-term perspective, however, economic policy and economic growth is about resource allocation, meaning allocation of physical resources, that is, available tangible capital stock and labor. How much of the current production is devoted to consumption and how much to capital investment? Looking for economic health and strength, generations of economists have focused on two economic aggregates: savings and investment, in particular net savings and net investment.

It used to be a truism among economists of all schools of thought that the growth of an economy's tangible capital stock is the key determinant of increased productivity and subsequently of good, high-paying jobs. And it also used to be a truism for economists that from a macroeconomic perspective, tangible capital investment into factories, production equipment, and commercial and residential building represents the one and only genuine wealth creation.

CORRUPTED THINKING IN A MONEY CULTURE

In America's new money culture, policymakers and economists make no difference anymore between wealth created through saving and investment in the real economy and wealth created in the markets through asset bubbles, created by extremely loose money and credit.

In 1996, an article in *Foreign Policy* entitled "Securities: The New Wealth Machine," explained how securitization — the issuance of high-quality bonds and stocks — has become the most powerful engine of wealth creation in today's world economy. Whereas societies used to accumulate wealth only slowly, they can now do so quickly and directly, and "*the new approach requires that a state find ways to increase the market value of its productive assets.*" In such a strategy, "*an economic policy that aims to achieve growth by wealth creation therefore does not attempt to increase the production of goods and services, except as a secondary objective.*"

This a perfect description of the corrupted economic thinking that is today ruling in America not only in corporations and the financial markets, but even among policymakers, elevating wealth-creation, that is, bubble-creation, to the ultimate of wisdom in the policy of economic growth.

There can be no question that the rapid sequence of asset bubbles — stocks, bonds, housing — that the United States has seen in the past few years were crucial in stimulating economic growth. Considering, though, its tremendously lopsided effect on consumer spending and the associated consumer-borrowing orgy, we are unable to regard this as a reasonable and sustainable policy. It works in the short run from the demand side, but it has come at heavy structural costs.

With these remarks, we wanted to make one thing perfectly clear. It is not profits, savings and investment that drive U.S. economic growth. It is America's unparalleled credit machine, and that alone, that makes all the difference in economic growth and wealth creation between America and the rest of the world.

Lately, China is overtaking the United States with faster credit and economic growth. But its boom has a completely different structure. Like in Japan, it is investment-driven. China's investment ratio is close to 38% of GDP. One can only hope that China does not make Japan's mistake to let credit expansion run out of control.

BETTING AGAINST THE CONSENSUS

In the consensus view, the U.S. economy is breaking out of its anemic growth pattern. A few signs of accelerating economic growth have led to this forecast, in particular the 8.2% spurt of real GDP growth in the third quarter of 2003 and within it sharply higher investment technology spending, up 22%; surging profits, and also surging early indicators, among them in particular the November ISM survey for manufacturing. Various indicators are at their strongest in 20 years.

We strongly disagree. Manifestly, the growth spurt in the third quarter was exceptional, due to a one off splurge in tax rebates and a burst in the mortgage refinancing wave. As to investment spending, what essentially matters is the change in total nonresidential investment, and that continues to show virtual stagnation. The widely hailed surge in IT investment came overwhelmingly from the hedonic pricing of computers, which has been abolished. About profits, we have already expressed our critical observations.

Our disbelief in the U.S. economy's breakout from its protracted sluggishness has one main reason: All the economic growth of the past two years, anemic as it was, is traceable to a seemingly endless array of asset and borrowing bubbles. Quoting analyst Stephen Roach, *"the Fed, in effect, has become a serial bubble blower"* — first the stock market bubble; then the bond bubble; then the housing bubble and the associated mortgage refinancing bubble. As a result, consumer spending has been surging well in excess of disposable income for years.

The idea was that sustained and rising consumer spending would in due time stimulate investment spending. It has grossly failed to do that. Our assumption rather is that consumer spending will slow as the asset and consumer borrowing bubble are sure to fade. Seeing no the big investment recovery, we expect a surprisingly weak U.S. economy in 2004.

SOFT OR HARD LANDING OF THE DOLLAR?

Writing and thinking about the U.S. economy, one question is increasingly uppermost in our mind. Will the dollar have a soft or hard landing? It is the question that will decide in the next few years about huge fortunes being lost and made.

A soft landing means a gradual decline causing no serious disturbances in the U.S. financial markets. The hard landing or crash of the dollar would arise when foreigners drastically slash their investment flows into the United States. The point to see here is that this would not just send the dollar crashing. With no intervention in the exchange markets, a sudden rupture of private capital inflows would also hammer the U.S.

bond and stock market, both having equally become hostage to a large continuing inflow of foreign capital.

As a matter of fact, this has already happened. Private foreign investment into U.S. assets has slumped. However, the Fed shows soaring holdings of U.S. bonds on account of foreign central banks, accruing from their interventions in the currency markets to slow or prevent a rise of their currencies. Over the last year, these holdings soared by about $200 billion, comparing with the current-account deficit of around $550 billion.

But speaking and thinking of the risks to the dollar, we must not only look at the trade deficit and current capital inflows. The same and, actually, far greater risk lurks in the existing huge holdings of dollars by foreign private and institutional investors. If the dollar's fall begins to frighten their foreign owners, they will sell from this immense stock of dollar assets.

At end — 2002, foreign gross holdings of dollar assets amounted to $8,576 billion at current costs and at $9,078 billion in market value. Market valuations were actually down from the year before because losses in the stock market (more than $800 billion) more than offset total new capital inflows.

The single biggest item among the foreign-owned dollar assets was direct investments amounting to $2,006 billion. Next were foreign private holdings of corporate and agency bonds with $1,690 billion, and then private holdings of U.S. stocks with $1,170 billion. Foreign official and private holdings of U.S. Treasury securities amounted to $1,214 billion.

The point to see is that these huge foreign dollar holdings are equally a big, looming threat to the dollar, perhaps the biggest threat of all. If their foreign owners lose confidence in the U.S. economy and the dollar, they will sell and switch the dollar proceeds into a stronger currency.

This is, by the way, a crucial difference to the dollar crisis of the 1980s. Private holdings of dollar assets were minimal at the time. The main source of the strong dollar had been bank borrowing in the Eurodollar markets. Remember, money was tight and expensive in the United States.

At the very least, foreign owners of dollar assets may decide to hedge their currency risk by selling equivalent dollar amounts forward. But that tends to depress the dollar's spot rate in the same way as direct dollar selling because the American or foreign banks that buy these forward dollars will under such conditions immediately cover themselves by selling spot dollars.

Considering the trillions of dollar assets held by foreigners, largely Europeans, we regard future large-scale hedging against a falling dollar as the biggest threat for the whole U.S. financial system, actually for the world financial system as whole. A foreign owner of dollar assets may for some reason want to keep the assets. But being unsure about the dollar, he decides to cover the exchange risk by selling dollars forward for a few months or even years.

It is easily done, and what's more, it costs nothing. Thanks to America's rock-bottom short-term interest rates, it even brings a small profit against most currencies. This, also, is an unprecedented experience. Normally, such hedging is quite expensive as countries with a weak and falling currency usually have high interest rates.

It is for this reason, too, that we lack any understanding or sympathy for European corporate managers complaining about large profit losses due the plunging dollar. Why don't they do the profitable hedging? We have to presume they fail to hedge because they believe in a strong dollar over time. There has been, and remains, a general conviction that the U.S. economy, in comparison to the eurozone economy, is of superior strength in the long run, and that this will sooner or later reassert itself in the exchange markets in a stronger dollar.

WHAT CAN STABILIZE THE DOLLAR?

It always amazes us how many questions are asked and pondered about the dollar's prospects. The key cause of its slide, of course, is the fact that capital inflows are more and more lagging the stubborn current-account deficit. As long as this lag lasts, the dollar will fall.

In principal, there are two radical solutions to stabilize and strengthen the dollar: *First*, the United States must offer higher rates of return on assets than Europe and Japan to restore high capital inflows; and *second*, it must curb its trade deficit by drastic monetary and fiscal tightening.

It hardly needs any explanation that neither of the two has the slightest chance to materialize. We go a step further in stating that the Greenspan Fed will do nothing to defend the dollar. It cannot for a compelling reason. Both the economy and financial markets, both being completely based on financial leverage and carry-trade, would collapse.

CONCLUSIONS:

There appears to be widespread hope that the declining dollar will reduce the U.S. trade deficit to levels that can be sustained by reduced capital inflows. Past experience gives no cause for such hopes.

To emphasize the main point: The chronic U.S. trade deficit reflects exceptionally high levels of consumption, undersaving and underinvestment. Improving the trade deficit requires a major correction of these imbalances. America's bond and stock market are far too fragile to allow serious monetary tightening.

U.S. economic growth during the last two years has been overwhelmingly bubble-driven. But as the bubbles are fading, U.S. economic growth will slow sharply in 2004, essentially accelerating the dollar's decline.

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